safeguards more, than assumed by the Commission in Computer III. The Commission should therefore retain Computer II's structural separation requirements.

IV. EXPERIENCE DEMONSTRATES THAT THE BENEFITS OF STRUCTURAL SEPARATION CANNOT BE ACHIEVED THROUGH NONSTRUCTURAL SAFEGUARDS.

When the Commission first decided to replace structural separation with nonstructural safeguards in Computer III, it had little experience with nonstructural safeguards on which to base its conclusion. Since that time, much has transpired which demonstrates that nonstructural safeguards are not capable of preventing anticompetitive abuse on the part of the BOCs in the provision of enhanced services. The Commission should not ignore that experience.

When the Commission last acted in the Computer III Remand Order, the Ninth Circuit set aside its decision largely because the Commission failed to address adequately evidence that nonstructural safeguards had not, in practice, prevented the BOCs from engaging in anticompetitive abuse. Just as it was then, it is incumbent on the Commission now to examine the evidence presented regarding the efficacy of its nonstructural safeguards. The evidence in the first Computer III remand proceeding, as well as the evidence that has accumulated in the past four years regarding the litany of abuses perpetrated by the BOCs, indicate that nonstructural safeguards have not improved with age and that they remain incapable of preventing both access discrimination and cross-subsidization.

A. The Nonstructural Safeguards Identified by the Notice Are As Inadequate Now As They Were When First Proposed in Computer III.

In California III, the Ninth Circuit concluded that the Commission had failed to demonstrate that nonstructural safeguards are effective in preventing access discrimination. The reason the Commission failed to do so is that it cannot do so. The nonstructural safeguards identified in the Computer III were inadequate when adopted, and nothing has changed in the intervening years to improve them in any meaningful way.

1. Nonstructural safeguards do not prevent access discrimination. The Notice catalogues a variety of nonstructural safeguards that have been adopted by the Commission and requests comment on their efficacy in preventing access discrimination.[33] As demonstrated below, these safeguards have proven to be incapable of preventing access discrimination.

a. CEI is Ineffective Without an ONA Regime That Includes Fundamental Unbundling.

The Notice indicates that the Commission, in the Computer III Phase I Order, "concluded that CEI would deter access discrimination by the BOCs."[34] In discussing CEI, the Notice suggests that CEI's effectiveness has been cited with approval by the court in California III.[35] As noted above,[36] the Commission has misread California

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[33] Notice ¶¶ 14-34.

[34] Id. ¶ 18.

[35] Id. ¶¶ 9-11, 18.

[36] See supra pp. 15-19.

III. The Ninth Circuit did not find CEI to be effective in deterring access discrimination. In fact, the court specifically concluded quite the opposite.[37]

The CEI rules adopted in Computer III and readopted in the Computer III Remand Order required the BOCs to make available to competing ESPs the basic service functions used by the BOCs in providing their own enhanced services.[38] CEI is intended to provide ESPs with unbundled basic services that are relatively equal in terms of technical specifications, functional capabilities, quality, and operational capabilities to the services which the BOCs themselves use.[39] Assuming that the BOCs comply with the CEI requirements, ESPs should, in theory, be able to provide the exact same enhanced services, provisioned in the exact same manner, on an equal basis with the BOCs.

If CEI were to accomplish this goal, it still would not be effective in preventing access discrimination. An ESP may require different network functionality than a BOC to efficiently provision its service. Under CEI, however, ESPs are not permitted to pick and choose the basic service "building blocks" needed to create their own enhanced services.[40] Rather, ESPs are entitled to choose only the building blocks that the BOCs use for their enhanced services. CEI thus allows the BOCs to improve their basic network operations in ways that advantage their own enhanced service operations and that disadvantage their competitors.

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[37] California III, 39 F.3d at 930.

[38] See Computer III Phase I Order, 104 F.C.C.2d at 1036.

[39] Id. at 1063 & n.210.

[40] See California II, 4 F.3d at 1511.

In Computer III, the Commission conceded as much and concluded that the success of CEI as a competitive safeguard was dependent on the effectiveness of ONA. The Ninth Circuit similarly concluded that CEI could not stand on its own: "[CEI] safeguards are not a substitute for ONA and, without ONA, are not adequate to prevent access discrimination."[41] The Commission, however, has fundamentally changed ONA, as the court found in California II, and, as changed, ONA is no longer effective in preventing access discrimination, as the court found in California III. CEI is therefore an ineffective safeguard, both by itself and in conjunction with ONA.

The ineffectiveness of CEI as a competitive safeguard is confirmed by the less-than-positive experience with the BOCs' integrated provision of enhanced services pursuant to approved CEI plans. Notwithstanding CEI requirements, the BOCs have impeded competition by denying ESPs timely access to basic services and by using their integrated operations to "unhook" ESP customers. The MemoryCall case, discussed more fully below, demonstrates the degree to which CEI permits a BOC to limit competition, even in those circumstances where BOCs and ESPs provide exactly the same service.

b. ONA Has Not Created a "Self-Enforcing" Mechanism to Prevent BOC Access Discrimination.

The Commission has described ONA as the "centerpiece" of its system of nonstructural safeguards.[42] Nearly a decade after the Commission began Computer III, the conclusion is inescapable that ONA has failed. ONA's failure is the direct result of two

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[41] California III, 39 F.3d at 930.

[42] Supplemental Brief of Federal Communications Commission, California v. FCC, No. 87-7230 (9th Cir. Mar. 3, 1989).

the conclusion is inescapable that ONA has failed. ONA's failure is the direct result of two decisions taken by the Commission. First, the Commission has abandoned the requirement that the BOCs fundamentally unbundle their basic networks. Instead, it has allowed the BOCs to implement a "diluted"[43] form of ONA in which few useful network components have been made available. Second, the Commission has required ESPs to pay the equivalent of Feature Group access charge rates in order to obtain ONA services, the effect of which is to render the few available features unaffordable.

Because it offers too few features at too high a price, unaffiliated ESPs have overwhelmingly declined to purchase ONA services. Indeed, the principal customers for virtually all ONA offerings are the BOCs themselves (and IXCs forced to replicate Feature Group Service through the purchase of Basic Serving Arrangements ("BSAs") and Basic Service Elements ("BSEs")). Having been rejected by the marketplace, ONA cannot be embraced by the Commission as the foundation for its efforts to prevent BOC access discrimination.

The Commission Has Abandoned Its Requirement That the BOCs "Fundamentally Unbundle" Their Networks. As originally conceived, ONA was intended to result in a fundamental unbundling of the BOCs' networks into "basic service 'building blocks'" -- "including signalling, switching, billing, and network management" -- that ESPs could use to develop competitive offerings.[44] Because each component of the network would be separately available on nondiscriminatory terms, the Commission asserted, the

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[43] California III, 39 F.3d at 929.

[44] Computer III Phase I Order, 104 F.C.C.2d at 1040 & 1063-65.

BOCs would be unable to discriminate against rival ESPs in the provision of network access. As a result, the Commission insisted, "ONA would be a 'self-enforcing' mechanism in controlling discrimination."[45] Based on these assurances, the Ninth Circuit concluded in California I that the Commission had made "a plausible case that ONA . . . will be effective in reducing the risk of BOC access discrimination."[46]

Almost from the beginning, however, the Commission has acquiesced in the BOCs' efforts to eviscerate ONA. As required by the Commission, the BOCs submitted ONA Plans in February 1988. The BOCs openly admitted that their plans did not even attempt to meet the Commission's ONA standards. BellSouth, for example, stated that its ONA Plan did "not propose . . . a new network architecture designed specifically to achieve the Commission's goals."[47] Rather, the BOCs' ONA Plans did little more than assign new names to network services that were already available under their existing tariffs.

The Commission did not order the BOCs to conform their ONA Plans to meet its requirements. Instead, the Commission modified its requirements to accommodate the BOCs' Plans. Rather than providing for the "fundamental unbundling" of the network,[48] ONA was reduced to nothing more than a "long-term, evolutionary process."[49] As a result

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[45] Id. at 1063.

[46] California I, 905 F.2d at 1238.

[47] BellSouth Open Network Architecture Plan at 3 (Feb. 1, 1988).

[48] Filing and Review of Open Network Architecture Plans, 5 FCC Rcd 3084, 3086 (1990) [hereinafter "ONA Reconsideration Order"].

[49] Filing and Review of Open Network Architecture Plans, 5 FCC Rcd 3103, 3105 (1990) [hereinafter "ONA Amendment Order"].

of the Commission's policy shift, ONA has never been an effective safeguard against BOC access discrimination.

The ONA Plans approved by the Commission suffer from numerous deficiencies. The Plans are based on a "Common ONA Model" which classifies various offerings as BSAs and BSEs. In theory, the BSAs are to provide unbundled access to the carriers' networks; BSEs are supposed to include additional unbundled "features and functions" that an ESP might require to develop a service offering. In reality, however, neither the BSAs nor the BSEs provide ESPs with nondiscriminatory access to the unbundled network components that they require to compete effectively against the BOCs.

The BSAs do not constitute unbundled access links. Rather, the Commission has allowed the BOCs to repackage their existing Feature Group Service as BSAs.[50] This is not an acceptable alternative. The BOCs designed the Feature Groups to meet the needs of interexchange carriers. These offerings bundle transport service with a large number of features that an IXC can use to access and terminate long distance voice traffic. Many of these features, however, are of no use to ESPs, such as carrier presubscription, designed to allow voice customers to access their long distance carrier by means of "1+" dialing. The result is that -- rather than promoting unbundling of the carriers' networks -- ONA requires ESPs to purchase additional features that they do not want or need.

The existing BSEs are similarly inadequate. These features consist of software-defined switching features, such as Call Forwarding or Calling Number

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[50] See Amendment of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, 6 FCC Rcd 4524, 4527-28 (1991) [hereinafter "Part 69 ONA Order"].

Identification, that are little more than "add ons" to the core network functions. As demonstrated in the Hatfield Report, the BOCs have not deployed BSEs uniformly, and large numbers of BSEs remain unavailable nationwide.[51] In the absence of fundamental unbundling of core network components, the availability of these "bells and whistles" does little to prevent the BOCs from engaging in access discrimination.

The enhanced service industry, including ITAA, made clear during the Commission's initial consideration of ONA that there were at least five core network elements that the BOCs would have to unbundle if ONA was to be an effective means of preventing access discrimination.[52] Specifically:

- The BOCs must allow ESPs to physically collocate ESP-provided equipment in the BOCs' central offices.
- BOC-provided switching and transmission links must be unbundled in order to allow ESPs to provide these components themselves or purchase them from other providers.
- ESPs must be given the ability to "interposition" ESP-provided equipment between an end user's CPE and a BOC's central office.
- Business and private line service should be made available without having to obtain a BOC-provided local loop.
- ESPs must be given direct access to remote line concentration equipment, which is required to efficiently

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[51] See Hatfield Report at 11-12.

[52] See, e.g., Comments of ADAPSO, Filing and Review of Open Network Architecture Plans, at 52-53 (Apr. 18, 1988).

provide service to geographically concentrated groups of customers.[53]

By approving the BOCs' common ONA model, the Commission denied the ESP community's request that these building blocks be part of ONA.[54] In other words, in approving the common ONA model, the Commission doomed ONA to failure at the very outset.

The Commission's Imposition of Carrier Access Charges Has Made ONA Unaffordable for Most ESPs. The Commission's failure to require fundamental unbundling of the BOCs' networks is only half the problem. As a result of the Commission's pricing policies, which require ESPs that wish to obtain interstate ONA services to pay subsidy-laden carrier access charges, most ESPs have been "priced out of the market" for ONA services. The Commission's ONA program clearly cannot curtail the ability of the BOCs to obtain network services on a discriminatory basis if ONA services are priced at a level that makes it uneconomical for unaffiliated ESPs to purchase them.

Historically, ESPs -- like other communications users -- have accessed the interstate network using state-tariffed business lines. These lines, which are priced on a flat-rate basis, provide an economic means for ESPs to provide service. The Commission, however, has held that ESPs that wish to purchase federally tariffed ONA BSEs must access

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[53] See generally Hatfield Associates, Open Network Architecture: A Promise Not Realized, at 96-106 (Apr. 5, 1988) (describing the BOCs rejection of various industry proposals regarding ONA) (filed in the record of CC Docket No. 88-2).

[54] The Notice cited certain features now available under ONA, such as Signalling System 7 ("SS7"), ISDN and Intelligent Networks. Notice ¶¶ 23-24. Not only are these features ineffective in preventing access discrimination, but they may actually increase the possibility of such discrimination. See Hatfield Report at 17-29.

the network using a federally tariffed BSA.[55] Unfortunately, the Commission rejected a suggestion, advanced by the ESP community, that the BOCs be required to offer a flat-rate, cost-based interstate BSA.[56] Rather, the Commission concluded that ONA BSAs should be priced like existing Feature Groups.[57]

The result is a Hobson's choice: ESPs can continue to use state-tariffed business lines and forego ONA or they can pay interstate carrier access charges and use ONA. This, of course, is no choice at all. Evidence provided to the Commission in the Part 69 ONA proceeding indicated that carrier access charges could increase ESPs' access costs by as much as 700 percent.[58] As a result, if an ESP were to purchase a federally tariffed BSA and reflect these rates in its prices, it would see the market for its services evaporate. It is for this reason that ESPs have overwhelming declined to purchase ONA services.

The Commission's acquiescence in the BOCs' evisceration of ONA precipitated the present remand proceeding. As the Commission again weighs the costs and benefits of replacing structural separation with nonstructural safeguards, it must deal candidly with the failure of ONA. As currently implemented, ONA cannot provide a viable means for ESPs to gain access to regulated network functions on the same terms and conditions as

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[55] See ONA Reconsideration Order, 5 FCC Rcd at 3085. The Commission rejected a suggestion that ESPs be allowed to "mix-and-match" state-tariffed access arrangements with federally tariffed BSEs. See Part 69 ONA Order, 6 FCC Rcd at 4535.

[56] Part 69 ONA Order, 6 FCC Rcd at 4535.

[57] Id.

[58] See, e.g., Comments of Tymnet-McDonnell Douglas Network Systems Company at 19-21 (Aug. 10, 1989); Comments of ADAPSO at 38-40 (Aug. 10, 1989); see also Hatfield Report at 12-13.

the carriers. Consequently, if structural separation were to be lifted, the carriers would have the ability to provide their enhanced service operations with insurmountable competitive advantages.

c. The Commission's Other Nonstructural Safeguards Are Inadequate to Prevent BOC Access Discrimination.

In the Notice, the Commission states that "[t]here is evidence that . . . [the CPNI, network disclosure, and nondiscrimination reporting requirement] safeguards have been effective" in preventing access discrimination.[59] The more substantial body of evidence, however, points in the opposite direction. The Commission's existing safeguards have not been -- and cannot be -- effective in preventing the BOCs' enhanced service operations from enjoying preferential access to the network.

The CPNI Rules Authorize, Rather Than Restrict, Discriminatory Access to Commercially Valuable Network Information. The question implicitly raised by the Notice is whether the existing CPNI rules are effective in preventing access discrimination. The answer, it seems clear, is that they are not. Indeed, by their very terms, the rules are designed to give the BOCs' enhanced service operations preferential access to the vast majority of CPNI.

CPNI is information that a communications common carrier gains, as a result of providing regulated transmission services, regarding customer use of the basic communications network. As the Commission recognized in the Computer III Remand Order, this information is commercially valuable. It can be used to: identify potential new

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[59] Notice ¶¶ 28-29.

enhanced service customers; target a rival ESP's existing customers; and tailor marketing presentations based on information about individual customers. Consequently, access to such information by carrier personnel involved in the development and marketing of enhanced services provides the carriers with an unfair competitive advantage over unaffiliated ESPs.[60]

The current CPNI rules, it has often been noted, are asymmetrical. The BOCs are required to obtain prior customer approval before using the CPNI of large business customers (defined as those with twenty or more telephone lines) to develop or market enhanced services, but are allowed unrestricted access to the CPNI of residential and small business customers. In establishing these rules, the Commission clearly recognized that unrestricted access to residential and small business customer CPNI would provide the BOCs with a competitive advantage. For example, the Commission stated that its rules would allow a BOC network service representative to identify basic service customers who might be interested in services (such as voice messaging) and, when such customers called, to market enhanced services to them.[61] The Commission, however, made a conscious decision to give the BOCs a competitive advantage because it believed that this would help create "a mass market for enhanced services."[62]

The Commission's CPNI rules are also deficient in their treatment of aggregate CPNI. As currently framed, the Commission's rules require the BOCs to make

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[60] See Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards, 6 FCC Rcd 7571, 7611 (1991) [hereinafter "Computer III Remand Order"].

[61] Computer III Remand Order, 6 FCC Rcd at 7610.

[62] Id. at 7609-10.

available to independent ESPs any aggregate information that they provide to their own enhanced service operations. Under this requirement, however, a BOC is only required to provide independent ESPs with the precise data requested by its own enhanced service operations, and is not obligated to provide other available information. Nor is a BOC required to advise the Commission of the aggregate CPNI which has been made available to its own enhanced service operations. Thus, unless an unaffiliated ESP knows what data have been disclosed to a BOC's own enhanced service operations and needs precisely the same data, it will be unable to obtain either the aggregate CPNI that has been disclosed or other aggregate CPNI that may be available.

In California III, the Ninth Circuit held that it was not arbitrary and capricious for the Commission to adopt CPNI rules that provide the BOCs with a competitive advantage in the enhanced service market in order to advance other policy goals.[63] The Commission, therefore, has the authority to do so. In assessing the efficacy of its nonstructural safeguards, however, the Commission is obligated to recognize that the CPNI rules -- which are one of its key nonstructural safeguards -- are intended to promote, rather than prevent, discriminatory access by the BOCs' enhanced service operations to valuable network information.[64]

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[63] See California III, 39 F.3d at 930-31.

[64] Cf. California III, 39 F.3d at 927-30 (although it was not arbitrary and capricious for the Commission to weaken its ONA policy, the Ninth Circuit made it clear that the Commission was obligated to consider the impact of such weakening in assessing the efficacy of ONA as a safeguard against access discrimination).

The Network Disclosure Rules Provide Only Limited Protection Against Access Discrimination. The Commission's network disclosure rules require the BOCs "to disclose information about network changes or new network services that affect the interconnection of enhanced services to the network . . . when the carrier decides to make itself, or procure from an unaffiliated entity, any product the design of which affects or relies on the network interface."[65] The goal of these rules is to prevent the BOCs' enhanced service operations from having an unfair competitive advantage as a result of preferential access to information about the network interface. Although the network disclosure rules do provide ESPs with useful information, they suffer from several fundamental defects that prevent them from being a fully effective deterrent to BOC access discrimination.

As an initial matter, network disclosure cannot substitute for the fundamental unbundling that ONA was supposed to provide. In order to compete effectively, ESPs need access to vastly increased forms of interconnection. The network disclosure rules, however, do no more than ensure that ESPs can use the same forms of interconnection that the BOCs choose to employ when they provide enhanced services.

Even accepting the network disclosure rules as they are, these rules are far from effective in ensuring that unaffiliated ESPs have the same opportunity as the BOC to design enhanced services that take advantage of new network interfaces. At the time it established the network disclosure rules, the Commission considered several options regarding the time at which disclosure must be made. The Commission rejected suggestions that the BOCs be required to disclose interfaces at the time they settled on a "stable design"

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[65] Computer III Phase II Order, 2 FCC Rcd at 3086.

for equipment that they were going to design or had made a "commitment to purchase."[66] The Commission instead chose to allow the BOCs to withhold interface information until the so-called "make/buy point." As a practical matter, this means that the BOCs have a "head start" in using interface information to design interoperable enhanced services.

The network disclosure rules also suffer from a further defect: compliance is entirely within the control of the BOCs. Non-carrier ESPs must rely on the BOCs to make disclosures that are both timely and comprehensive enough to allow them to develop interoperable services. There is evidence that the BOCs have not always complied with these obligations.[67]

The Non-Discrimination Reports Have Failed to Disclose Repeated Instances of BOC Access Discrimination. The Notice suggests that the nondiscrimination reports filed by the BOCs provide "evidence" that they have not engaged in access discrimination.[68] The Commission, however, should accord little weight to these reports, which are of little practical value.

Computer III's non-discrimination reporting requirements obligate the BOCs to provide the Commission with quarterly reports and an annual affidavit stating that they are not discriminating.[69] ITAA will not comment on the value of such affidavits other than to note that they will always be filed, regardless of a BOC's actual practices. As concerns the

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[66] See id. at 3087.

[67] See, e.g., NYNEX Telephone Companies, Tariff F.C.C. No. 1, Transmittal No. 127, 8 FCC Rcd 7684 (1993), on remand, 9 FCC Rcd 1608 (1994).

[68] Notice ¶ 29.

[69] See id. ¶ 29 n.68.

BOCs' quarterly reports, they do nothing more than list the percentage of service appointments that the BOCs have canceled. There are no quantitative measures regarding service interruptions, quality of interconnections, willingness of the BOCs to accommodate service requests, user complaints, or other information that would allow for a comprehensive assessment of the quality of service that the BOCs are providing to ESPs and their customers. Moreover, what little data the BOCs do provide "lumps" unaffiliated ESPs with other customers; there is no head-to-head comparison of the service provided to the BOCs' own enhanced service operations and the service provided to competing ESPs.

As demonstrated below, there has been substantial evidence that the BOCs have engaged in access discrimination. In no case, however, have the Commission's nondiscrimination reporting requirements led to the detection of these abuses. There is thus only one conclusion that can be drawn: the Commission's nondiscrimination reporting requirements, like the other safeguards discussed in the Notice, have not proven to be effective in preventing BOC access discrimination.

d. The Expanded Interconnection and Intelligent Networks Proceedings Have Not Reduced the Ability of the BOCs to Engage in Access Discrimination Against Competing ESPs.

The Notice observes that the Commission has adopted virtual collocation requirements in the Expanded Interconnection proceeding,[70] and that it is "moving towards greater unbundling of network services in its Intelligent Networks proceeding."[71] Important as these proceedings are, they have not yet resulted in the

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[70] Notice ¶ 30.

[71] Id. ¶ 31.

proceeding."[71] Important as these proceedings are, they have not yet resulted in the fundamental network unbundling necessary to protect ESPs from BOC access discrimination, nor have they otherwise diminished the ability of the BOCs to engage in such discrimination. Consequently, these proceedings have little present relevance to the Commission's assessment of the costs and benefits of replacing structural separation with nonstructural safeguards.

As noted above, ESPs have long sought five basic forms of network unbundling. The Expanded Interconnection Orders provide one of these. Under the Expanded Interconnection regime, ESPs will be able to provide certain transmission functions themselves or purchase them from other providers. Expanded interconnection, however, does not meet the ESP community's longstanding request to physically collocate enhanced services equipment, such as file servers, in the BOCs' central offices.[72] Nor will it give ESPs the ability to "interposition" ESP-provided equipment between end user CPE and the BOCs' central offices or provide them with direct access to remote line concentration equipment. Further, the Commission has not yet required the BOCs to unbundle the local loop.

The Commission's Notice of Proposed Rulemaking in the Intelligent Networks docket holds out the promise of further unbundling. Under the Commission's proposal, users (including enhanced service providers) would be accorded "mediated" (i.e., indirect) access

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[71] Id. ¶ 31.

[72] The only collocation authorized is the virtual collocation of "basic transmission equipment" in the carriers' central offices. Even then, collocation opportunities are limited to entities that provide their own microwave or fiber optic transmission links. See Expanded Interconnection With Local Telephone Company Facilities, 9 FCC Rcd 5154 (1994).

to various intelligent functions within the BOCs' networks.[73] The Notice, however, is silent on an enormously critical issue: will the BOCs' enhanced service operations be required to access intelligent network functions through the same type of mediated access as unaffiliated ESPs? Indeed, mediated access inherently gives the BOCs the ability to limit the services that can be developed by competing ESPs.[74] If the Commission does not require the BOCs to take the same type of access as other ESPs, then the Intelligent Networks proceeding will increase, rather than reduce, their ability to engage in access discrimination.[75] In any case, consideration of what might happen in the Intelligent Networks docket is inappropriate in this proceeding. Nineteen months after issuing the Notice, the Commission still has not taken any action.[76]

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[73] See Intelligent Networks, Notice of Proposed Rulemaking, 8 FCC Rcd 6813 (1993).

[74] See Hatfield Report at 13-16.

[75] As discussed above, technological improvement such as SS7 give the BOCs greater opportunity to discriminate, rather than safeguard against anticompetitive behavior. See id. at 18-29.

[76] To the extent that the Commission concludes that consideration of the Intelligent Networks proceeding is relevant, it must take into account the BOCs' reactions to the Commission's proposals, which have ranged from lukewarm to outright hostile. See, e.g., Comments of U S West Corporation (Nov. 1, 1993) at 52-91 (opposing mediated customer access to Service Management Systems; claiming mediated access to Service Control Points and to the switch to be infeasible); Comments of Pacific Bell and Nevada Bell at 20-29 (expressing reservations about the cost of mediated access to Service Management Systems; claiming mediated access to the switch would present major network reliability problems); Comments of BellSouth Communications, Inc. at 12-19 (claiming FCC-mandated access to Service Management Systems and Service Control Points would stifle technological innovation, while access at the switch would make LECs "dependent on switch manufacturers for mediation software development and maintenance").

e. Market Forces Have Not -- and Cannot -- Prevent the BOCs From Engaging in Access Discrimination.

The Notice speculates that the growth of competition in the enhanced services market could provide a "check on successful access discrimination by the BOCs against competing ESPs."[77] This view is neither sound in theory nor consistent with the evidence.

The fundamental market reality is that the BOCs continue to enjoy bottleneck control over the local exchange monopoly. A decade after divestiture, they carry more than 99 percent of all local traffic in their service regions. The opportunities to use bypass facilities remain limited at best. Thus, no matter how competitive the enhanced services market is, all ESPs remain dependent on the BOCs for the communications services which they need to deliver their services to their customers. Moreover, contrary to the suggestions appearing in the Notice,[78] most ESPs are small businesses. Indeed, most of ITAA's member companies have annual revenues of less than $10 million. Thus, while there are also large companies in the enhanced services industry, most conflicts between ESPs and the BOCs will remain a David versus Goliath struggle. As explained in the Hatfield Report, the growth of enhanced services merely increases the incentive for the BOCs to act anticompetitively.[79] Indeed, competitors in a fiercely competitive market have more to gain from anticompetitive conduct than those in less competitive markets.

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[77] Notice ¶ 32.

[78] Notice ¶ 33 n.81.

[79] See Hatfield Report at 47-49.

rates. Under that approach, the Commission prescribed a rate of return designed to approximate the return on investment that the BOCs could expect to achieve in a competitive market. The BOCs then established prices for various services designed to recover their costs plus the specified return.[80] Because the BOCs' prices for a given service were supposed to be based on the cost of providing that service, the rate-of-return system limited the BOCs' pricing flexibility.

In 1991, however, the Commission replaced rate-of-return regulation with the current "price cap" regime. Under price caps, the BOCs' services are grouped into four "baskets." The BOCs have significant pricing flexibility within each basket, provided that the aggregate prices of all services within a given basket do not exceed a Commission-specified "cap."[81] Price caps are intended to reduce cross-subsidization by eliminating the incentive for carriers to shift costs to their regulated operations in order to justify higher rates. The price cap system -- which, as discussed above,[82] retains certain elements of rate-of-return regulation -- does not fully remove this incentive.

The Commission attempts to prevent cross-subsidization by auditing the carriers for compliance with its cost accounting and other rules. As the Hatfield Report explains in some detail, these rules are not only obsolete, but they also are inherently

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[80] See generally Policy and Rules Concerning Rates for Dominant Carriers, 2 FCC Rcd 5208 (1987) (describing the rate-of-return system).

[81] See generally Price Cap Performance Review for Local Exchange Carriers, 9 FCC Rcd 1687, 1689 (1994) (describing the LEC price cap system).

[82] See supra pp. 10-11.

complicated and difficult to administer.[83] Allocating the costs of personnel and facilities that are used to provide both regulated and unregulated services is, under the best of circumstances, an accounting nightmare. Auditing such allocations is equally difficult.

The Commission, however, lacks the resources necessary to administer these rules and audit the BOCs' compliance. A study conducted by the United States General Accounting Office ("GAO") in 1987 found that the Commission did not have adequate staff resources to monitor compliance with its rules. Indeed, the GAO report estimated that the agency could audit major carriers no more than once every 16 years.[84] The GAO report concluded that:

> Overall the level of oversight we see [the] FCC prepared to provide will not, in our opinion, ultimately provide telephone ratepayers or carrier competitors positive assurance that [the] FCC's joint cost rules will guard against cross-subsidy. Such assurance is important in the future with the growth in carriers' competitive ventures, the loosening of restrictions on their entry into more of these ventures, and the increased potential for undetected cross-subsidy in the absence of structural separation requirements.[85]

A follow-up report, issued in 1993, found that the situation had worsened. "On-site audit staff," GAO concluded, "have declined since 1987, while the staff's workload

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[83] See Hatfield Report at 41-44.

[84] See General Accounting Office, Telephone Communications: Controlling Cross-Subsidy Between Regulated and Competitive Services, RCED-88-34, at 51-54 (Oct. 1987).

[85] Id. at 54-55 (emphasis added).

. . . increased by 35 percent."[86] The GAO report estimated that the Commission would have to more than triple the size of its audit staff in order to audit each carrier once every five years. A five year audit cycle is desirable, because the Commission is barred by statute from imposing penalties for cost misallocations that occurred more than five years before the agency makes a claim.[87]

The GAO audit also criticized the Commission's Automated Reporting Management Information System ("ARMIS"), which is supposed to help the agency detect cross-subsidization by providing comparative data about the BOCs.[88] According to GAO, in only one inside wiring incident did the use of ARMIS result in the detection of cross-subsidization.[89]

Finally, GAO concluded that the Commission's reliance on outside certified public accountants ("CPAs") -- hired by the BOCs -- to determine compliance with the Commission's cost allocation rules was misplaced.[90] GAO found that the "CPA audits frequently have not been performed in compliance with FCC guidance."[91] As a result, the

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[86] General Accounting Office, Telecommunications: FCC Oversight Efforts to Control Cross-Subsidization, RCED-93-34, at 2 (Feb. 1993) [hereinafter "GAO Cross-Subsidization Report"]. To cope with this situation, GAO disclosed, the Commission had "implemented a number of strategies: reducing the scope of on-site audits, reducing the size of audit teams from three to two persons where possible, [and] targeting the most critical areas within the audit universe." Id. at 6.

[87] See id.

[88] See Computer III Remand Order, 6 FCC Rcd at 7593 & 7595.

[89] GAO Cross-Subsidization Report at 11.

[90] See id. at 8.

[91] Id.

"CPAs' testing has not always been adequate to ensure that carriers are complying with the cost allocation rules."[92]

The Commission repeatedly has stated in its published orders that its nonstructural safeguards are adequate to prevent BOC abuse.[93] As GAO has pointed out, however, the Commission itself has conceded in its budget submissions to Congress that its current "staffing level limits the assurance that [the agency] can provide . . . that carriers are complying with cost allocation rules and that regulated services are not cross-subsidizing unregulated operations."[94] Chairman Hundt expressed the same views in his congressional testimony. The size of the Commission's staff, he observed, is lower today than it was in 1980.[95] As a result, he stated bluntly, "[t]here is simply not enough staff for the Commission to do the work envisioned by Congress."[96] Given recent efforts to reduce the deficit and the size of the federal government, the Commission is only likely to see its resources shrink.

The competitive dangers presented by the Commission's lack of resources are compounded by the fact that the BOCs do not have to engage in widespread or extensive

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[92] Id.

[93] See, e.g., Computer III Remand Order, 6 FCC Rcd at 7595 (The Commission "has adequate resources to monitor the BOCs' activities.").

[94] GAO Cross-Subsidization Report at 5.

[95] See Statement of Chairman Reed E. Hundt Before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce Concerning the 1995 Authorization Act for the Federal Communications Commission at 6 (May 26, 1994).

[96] Id. at 1.

cost-shifting in order to be successful in disadvantaging their competitors. Unlike basic communications, enhanced services are generally provided pursuant to individual fixed-term contracts. This means that cross-subsidies do not have to take place on an across-the-board basis in order to be successful. Rather, they can be targeted to specific customers at specific points in time. Moreover, the demand for enhanced services is extremely price sensitive. This means that cross-subsidies do not have to be enormous in order to have an anticompetitive effect. These two traits, combined with the relative ease with which sizeable cross-subsidies can be effected, make cross-subsidization attractive and inevitable.

Furthermore, even if the Commission's overburdened auditors were able to eventually determine that illegal cross-subsidization has occurred, the most the Commission would be able to do is make ratepayers whole. Although not unimportant, ratepayer refunds do not repair the competitive damage which cross-subsidization causes competing ESPs. By the time an audit can detect (if at all) illegal cross-subsidization, the offending BOC will have already obtained the enhanced service contract or customer. The Commission cannot re-award such contracts nor make competing ESPs whole. Indeed, it cannot even ensure that future cross-subsidies will not occur.

In California I, the Ninth Circuit found that the Commission had failed to justify its new-found faith in the ability of accounting rules and auditing procedures to prevent cross-subsidization.[97] The Computer III Remand Order concluded that the court's concerns had been addressed by modification of the Commission's joint cost rules, ARMIS,

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[97] See California III, 39 F.3d at 926.

and the institution of improved auditing procedures.[98] As noted by GAO, however, these improvements have not been sufficient to prevent cross-subsidization by the BOCs. Fundamentally, there have been no real improvement in the Commission's auditing capabilities since California I. The Commission should therefore take the opportunity presented by this proceeding to reassess the efficacy of nonstructural safeguards in preventing cross-subsidization.

B. Experience Subsequent to Computer III Demonstrates That Nonstructural Safeguards Are Ineffective in Preventing Anticompetitive Abuse.

When the Commission first began Computer III, it had little experience with nonstructural safeguards. Indeed, it had little experience with Bell Company provision of enhanced services. It was not until well after California I that the BOCs were granted any significant relief from the information services restriction of the Modification of Final Judgment ("MFJ"). Even today, the BOCs are precluded from providing most interLATA enhanced services. Notwithstanding their limited entry into the enhanced services marketplace, the BOCs have proven the Commission's nonstructural safeguards to be a failure in preventing cross-subsidization and access discrimination. The Commission can only expect the situation to become worse if and when the BOCs are granted interLATA relief. If the BOCs have engaged in anticompetitive abuse when they are theoretically on their best behavior -- because of their hope of securing further MFJ relief -- and have less of a marketplace incentive to engage in such conduct -- because of their inability to compete

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[98] See id.; see also Computer III Remand Order, 6 FCC Rcd at 7595-97.